

## Focal Point

# Spanish elections: Still long negotiations to follow

June 22, 2016



**Author: Luca Colussa**

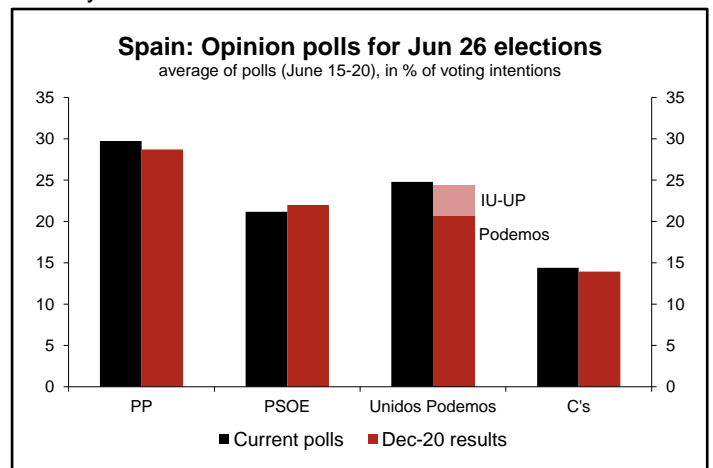
- Six months after the inconclusive December vote, Spain will face fresh general elections on Sunday (Jun 26). Opinion polls still point to a hung parliament and the negotiations over government formation will remain difficult in any case.
- The Socialists (PSOE) will remain the kingmaker. A People's Party (PP) minority government with the abstention of the PSOE or a pact between the latter and the left-wing Unidos Podemos seem both plausible in our view.
- The increasing consensus for Unidos Podemos could however favor the latter scenario. Such an event, jointly with a possible victory of the 'Leave' camp in the UK, would inevitably weigh on Spanish assets in the short term.
- That said, the Podemos risk should not be overrated in our view. Mr Iglesias' party would have to cooperate with the fiscally more diligent PSOE. In addition, their more pragmatic approach on Catalonia – opposed to PM Rajoy's fierce rejection of separatists' requests – could reduce the risk of a unilateral secession.

With all market attention deployed to the EU membership referendum in the UK tomorrow, the new general elections in Spain on Sunday (Jun 26) have remained on the sidelines. Indeed, the fears of a Brexit – and the hopes for a victory of the 'Remain' camp – have been the major driver in financial markets, which temporarily overlooked other political issues in the euro area. That said, the strong momentum of Unidos Podemos – the electoral alliance among the major Spanish left-wing forces – in opinion polls could shift the balance of powers in the country on Sunday's vote. Yet, a hung parliament and prolonged negotiations over the new government formation are still the most likely outcome. Investors have repeatedly shown signs of unease with Podemos because of its anti-austerity stance and its support to a referendum over the independence of Catalonia. Such worries would likely intensify greatly in case of a simultaneous victory of the 'Leave' camp in the UK and a strong performance of Mr Iglesias' party, weighing on Spanish assets in the short-term. That said, we believe that the Spanish political landscape deserves a more in-depth analysis to better assess the ultimate implications of the Sunday vote.

### A hung parliament again but Podemos advances

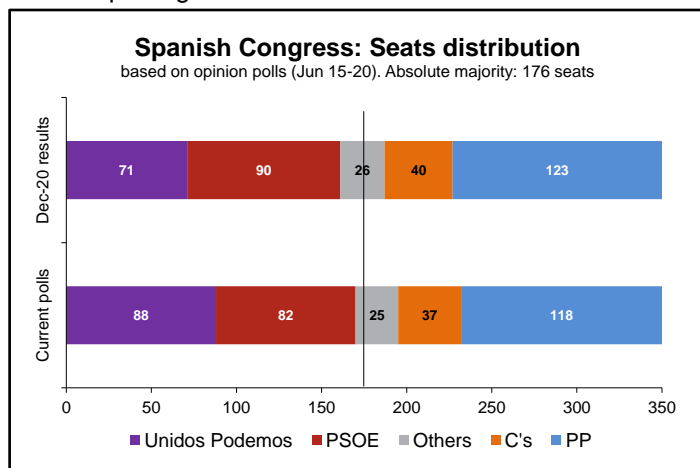
In early May, King Felipe VI dissolved the parliament and called snap elections following the failure in the negotiations for the new government after the inconclusive December vote. The mutual vetoes between the left-wing Podemos and the centrist Ciudadanos (C's) impeded a 3-party coalition led by the Socialists (PSOE), thus allowing PM Rajoy to remain at the helm of a caretaker cabinet.

In recent months, Podemos has been very active in expanding its influence by striking several electoral agreements with other left-wing forces both at national and regional level. The most important was the one with United Left (IU-UP), a party that secured 3.7% of total votes but which has only 2 seats (out of 350) in the Spanish Congress. The alliance – announced by the two party leaders on May 9 – was named Unidos Podemos.



Thanks to the peculiarity of the Spanish electoral system – which favors larger parties and coalitions over small parties – Unidos Podemos is now expected to become the second largest force in the Congress in terms of seats even though the current poll consensus (24.8%) is only marginally higher compared to the sum of the votes secured in the December vote (24.4%). According to opinion

polls, Unidos Podemos would gain 88 seats (from 71 before), surpassing the PSOE (down to 82 from 90 seats). On the center-right side, both PM Rajoy's People's Party (PP) and C's would lose some seats despite small gains in voting intentions. The remaining seats would be secured by the two Catalan separatist parties (ERC and DL) and by the Basque regionalists.



### Government formation: Beyond mutual vetoes

As happened in December, no political force would be able to rule on its own in such a scenario. As a result, a new round of negotiations will start soon after the vote. While remaining the largest party in terms of votes and seats, the center-right PP would again be in an unfavorable position as the other three major forces have repeatedly affirmed their refusal to back a cabinet led by the outgoing PM Rajoy. Should the latter resign, the centrist C's would be more willing to support the PP given their similar economic agenda, but such a coalition would fall well short of the absolute majority (it would control only 155 seats combined, down from 163 before and too distant from the absolute majority of 176). The PP needs to secure the support (or at least the abstention in the investiture vote) of the center-left PSOE, whose leader, Pedro Sánchez, is however firmly against such a solution. Only the combined resignations of PM Rajoy and Mr Sánchez could provide the green light to a grand coalition government between the PP and the PSOE or, more likely, to a PP-led minority cabinet with the abstention of the PSOE. This could however result in a severe erosion of consensus for the Socialists to the benefit of Unidos Podemos.

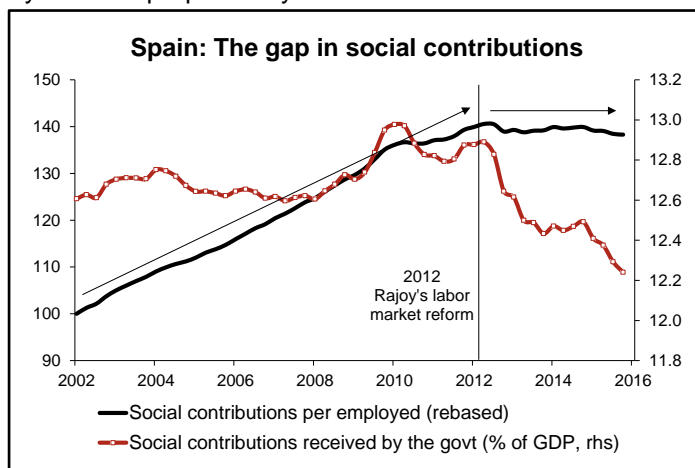
The most likely alternative scenario consists of a pact between the PSOE and Unidos Podemos. Such an alliance could count on around 170 seats (up from 161 before), thus approaching the threshold for the absolute majority. A strong showing by the left-wing force, like the ones shown by the most favorable pollsters, could even lead to a thin outright majority. However, arithmetic alone would not suffice to secure a durable deal between the two. Indeed, several hurdles remain in place. First, Mr Sánchez blames Podemos for having opposed to the pact between the PSOE and C's which was at the basis of the negotiations in the past months. In addition, he recently rejected the possibility to back Mr Iglesias as Prime Minister should Unidos Podemos surpass the PSOE, as suggested by the current opinion polls. A leadership issue would inevitably materialize. Second, the Socialists and Podemos would need to define a common strategy with regard to fiscal pol-

icies. We believe that Podemos will have to soften its spending increasing proposals and to support the more ambitious adjustment plan depicted the Socialists. Third, the PSOE urged Podemos to withdraw its support to the referendum on Catalan independence and to join the efforts to reform the constitution with a more federalist footprint. Last but not least, a leftish cabinet requires Mr Sánchez to survive resignation pressures from the hardliners of his own party in case of an electoral defeat. Under these hypotheses, a deal between the PSOE and Unidos Podemos would become reality. Only in a less likely scenario, Spain could be forced into the third snap election in less than one year.

### Which medicine for public finance?

The anti-austerity stance of Podemos would clearly be a cause of concern for investors. Indeed, Mr Iglesias' party aims to postpone the reduction of the fiscal deficit below the 3% threshold to 2019, three years beyond the original deadline set by the European Commission (EC). It also proposed to increase public spending by € 60 bn in the next four years in order to fund welfare projects. No doubt that the EC and financial markets would escalate the pressure should this plan materialize.

As said above, Unidos Podemos will have to find a compromise with the PSOE in case of victory. The two parties share a common ground on fiscal – no further cuts to the income tax, increase in social spending and introduction of a minimum income, reduction of regressive tax deductions, an increased role of wealth taxes – and economic policies – revision of PP's 2012 labor market reform in order to reduce temporary contracts – but Mr Sánchez has publicly labelled the projected increase in expenditure foreseen by Podemos' proposal as unsustainable. We believe that a common platform would be based on a less aggressive increase in social spending and less growth-impactful tax hikes, in order to bring the deficit below the 3% threshold by 2018 as proposed by the PSOE.

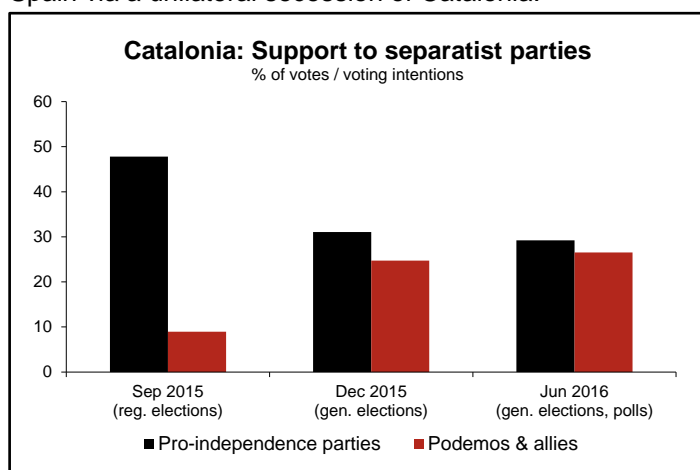


While markets could rightly be concerned about the less business-friendly policy mix proposed by the two leftish parties, the PP's fiscal framework comes with its own shortcomings. The alternative plan proposed by the PP foresees a reduction in the deficit based mainly on persistently strong economic growth, but it lacks credibility in our view. Indeed, the Spanish government has repeatedly missed its budget targets in recent years. In 2015, the deficit declined only to 5.1% of GDP (from 5.7% in 2014) compared to a target of 4.2%, despite the above expecta-

tions growth performance (real GDP expanded by 3.2% in 2015, the fastest pace since 2007). A large part of the slippage can be attributed to the widening deficit of the social security fund. Indeed, the gap rose from 0.1% of GDP in 2011 – when PM Rajoy assumed the office – to an unprecedented 1.3% of GDP in 2015. The PP has tapped the Social Security Reserve Fund aggressively, with total withdrawals of € 47.2 bn in the last four years, more than halving the fund's assets. The increase in pension expenditure accounts for the bulk of this deterioration (up from 12.5% of GDP in 2011 to 14.0% in 2014) since it has not been matched by a comparable rise in social contributions. The latter have actually decreased both in GDP and per-employed terms (see graph in previous page) since the approval of the labor market reform in 2012, which significantly contributed to the reduction in unit labor costs. While PM Rajoy played down this issue during the electoral campaign, the PSOE seems ready to promptly tackle it. On the other hand, the increase in taxation and the corrections to the labor market reform planned by the Socialists would compress corporate margins, likely weighing on the recovery in investments.

### No easy solution for Catalonia

The other hot topic of the electoral campaign is the stance on Catalan independence and the possibility of a referendum on it. While all the four major parties are against a separation, Podemos' support to a popular vote on the issue has scared investors and contributed to the failure of the previous round of negotiations between Podemos and the PSOE. A victory of the 'Leave' camp in the UK and a strong showing by Unidos Podemos in the Sunday's vote could ignite speculations over an ultimate break-up of Spain via a unilateral secession of Catalonia.



Once again, however, things are not that simple. The PSOE's stance is central given its kingmaker position and Unidos Podemos will have to adapt if it wants to strike a deal for the new cabinet. In the last week, Mr Iglesias stressed the need for a stronger coordination between the Partido de los Socialistas de Cataluña and En Comú Podem – the Catalan representation of the PSOE and Unidos Podemos – on this issue and hinted that the referendum proposal may not be a red line in the negotiations. We believe that these statements represent an attempt of Podemos to free itself from its controversial position, but surely the PSOE will ask for much more clarity on that.

When comparing the PP and the PSOE's solutions to the Catalan issue, we believe the Socialists' one has higher

chances to avoid a further surge of the separatist movement. Indeed, PM Rajoy and the PP have constantly rejected any dialogue with Catalan regional parties, contributing to aggravate the crisis. On the other hand, the PSOE is more willing to find a compromise while preserving the national unity. This would require a reform of the constitution granting more powers to regions, especially in terms of stronger fiscal autonomy and cultural recognition of the so called 'nacionalidades'. Nevertheless, the reform would not be an easy task despite the strong support for Unidos Podemos in those autonomous communities more impacted by regionalism. Indeed, the constitutional reform has to be approved also by the Senate, which would likely remain under the control of the PP though. This constitutes a key obstacle to a swift settlement of the Catalan issue.

In conclusion, we reiterate our view of a hung parliament as a baseline scenario. Given the very fragmented political landscape and the ideological differences among the parties, we also expect a prolonged period of negotiations similarly to the experience seen earlier this year. That said, we slightly favor an agreement between the PSOE and Unidos Podemos as the most likely outcome. In that case, the likely initial negative reaction to the rise of the left-wing party would ultimately be tempered by the kingmaker role of the PSOE. Moreover, in contrast to Greece and various other EU countries, moderate and pro-European parties will still make up for more than two thirds of members of parliament. Despite difficult and prolonged negotiations, we see little risk of a repetition of the disruptive Greek experience in the longer term.

# Imprint

<b>Head of Research (<i>ad interim</i>):</b>	Santo Borsellino (santo.borsellino@generali-invest.com)
<b>Deputy Head of Research:</b>	Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)
<b>Team:</b>	Luca Colussa, CFA (luca.colussa@generali-invest.com) Radomír Jáč (radomir.jac@generali.com) Jakub Krátký (jakub.kratky@generali.com) Michele Morganti (michele.morganti@generali-invest.com) Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com) Dr. Martin Pohl (martin.pohl@generali.com) Dr. Thorsten Runde (thorsten.runde@generali-invest.com) Frank Ruppel (frank.ruppel@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri (paolo.zanghieri@generali.com)
<b>Edited by:</b>	Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com) Tamara Hardt (tamara.hardt@generali-invest.com)
<b>Issued by:</b>	Generali Investments Europe Research Department Cologne, Germany · Trieste, Italy Tunisstraße 19-23, D-50667 Cologne
<b>Sources for charts and tables:</b>	Thomson Reuters Datastream, Bloomberg, own calculations

**In Italy:**  
Generali Investments Europe  
S.p.A SGR

Corso Italia, 6  
20122 Milano MI, Italy

**In France:**  
Generali Investments Europe  
S.p.A SGR

2, Rue Pillet-Will  
75009 Paris Cedex 09, France

**In Germany:**  
Generali Investments Europe  
S.p.A. SGR

Tunisstraße 19-23  
50667 Cologne, Germany

[www.generali-invest.com](http://www.generali-invest.com)

This document is based on information and opinions which Generali Investments Europe S.p.A. Società di gestione del risparmio considers as reliable. However, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. Opinions expressed in this document represent only the judgment of Generali Investments Europe S.p.A. Società di gestione del risparmio and may be subject to any change without notification. They do not constitute an evaluation of any strategy or any investment in financial instruments. This document does not constitute an offer, solicitation or recommendation to buy or to sell financial instruments. Generali Investments Europe S.p.A. Società di gestione del risparmio is not liable for any investment decision based on this document. Generali Investments Europe S.p.A. Società di gestione del risparmio may have taken, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein. Any reproduction, total or partial, of this document is prohibited without prior consent of Generali Investments Europe S.p.A. Società di gestione del risparmio. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro-Italiane. Generali Investments is a commercial brand of Generali Investments Europe S.p.A. S Società di gestione del risparmio.